Islamic Corporate Financing:

Does it Promote Profit and Loss Sharing?

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Abstract

Islamic financing instruments can be categorised into profit and loss/risk sharing and non-participatory instruments. Although profit and loss sharing instruments such as musharakah are widely accepted as the ideal form of Islamic financing, prior studies suggest that alternative instruments such as murabahah are preferred by Islamic banks. Nevertheless, prior studies did not explore factors that influence the use of Islamic financing among non-financial firms. Our study fills this gap and contributes new knowledge in several ways. First, we find no evidence of widespread use of Islamic financing instruments across non-financial firms. This is because the instruments are mostly used by less profitable firms with higher leverage (i.e., risky firms). Second, we find that profit and loss sharing instruments are hardly used, whilst the use of murabahah is dominant. Consistent with the prediction of moral-hazard-risk avoidance theory, further analysis suggests that users with a lower asset base (to serve as collateral) are associated with murabahah financing. Third, we present a critical discourse on the contentious nature of murabahah as practised. The economic significance and ethical issues associated with murabahah as practised should trigger serious efforts to steer Islamic corporate financing towards risk-sharing more than the controversial rent-seeking practice.

Key words: Capital Structure; Islamic Finance; Islamic Financial Instruments; Malaysia; Profit and Loss Sharing; Murabahah

Introduction

The presence of the Islamic finance industry in the global capital market is increasingly acknowledged. Unfortunately, the development of this industry has not been without issues. In theory, profit and loss/risk sharing has been accepted as the epistemological foundation of Islamic finance because it is consistent with the Islamic philosophy of promoting fairness (Ayub, 2007; Mirakhor and Smolo, 2013). In practice, the cornerstone of the growth in Islamic finance, thus far propelled by governments and the strong participation of financial institutions, has been criticised for deviating from profit and loss sharing (Warde, 2000; Saleem, 2005; Ayub, 2007; Raphaeli, 2009; Khan, 2010). The divergence between theory and practice is indeed an interesting issue (Rice, 1999). This issue motivates us to explore the reality of Islamic corporate financing with three research questions in mind, as described below.

First, despite numerous positive claims regarding the growing importance of Islamic finance (e.g., Financial Times, 2011), we still do not know to what extent non-financial firms are using Islamic instruments in corporate financing, and why. Prior studies have mainly documented financing instruments offered by Islamic banks (e.g., Aggarwal and Yousef, 2000; Chong and Liu, 2009; Khan, 2010), but the literature falls short of providing empirical evidence on the use of Islamic financing instruments by non-financial firms. This gap in knowledge motivates us to provide such empirical evidence as a novel contribution to the literature.

Second, we question which type of Islamic financing instruments is most used by non-financial firms, and why. Appendix 1 summarises the different types of Islamic instruments. While profit and loss-based instruments such as musharakah are mostly preferred because they are consistent with the Islamic philosophy of promoting fairness (Ayub, 2007; Mirakhor and Smolo, 2013), the way that alternative instruments such as murabahah is practised, has been

criticised by many learned scholars (Saleem, 2005; Ayub, 2007; Khan, 2010). Although previous studies have recognised the preference of Islamic banks for offering murabahah financing (Aggarwal and Yousef, 2000; Chong and Liu, 2009; Khan, 2010), it is still empirically unknown which instrument is more often used among non-financial firms. This gap in the knowledge motivates us to identify the most commonly used Islamic instrument and explore factors that might influence such usage among non-financial firms.

Third, we question whether murabahah as practised can be considered ethically sound. This line of inquiry is motivated by the prospect that Islamic finance might be able to create a socially responsible, ethical and stable financial system (Kayed and Hassan, 2011; Ullah et al., 2014). Our critical discourse on murabahah as practised aims to reinforce the significance of the empirical evidence presented in this study. This discourse is not unreasonable given that a number of Sharia scholars, legal scholars, Islamic finance practitioners and academics have also raised ethical concerns about the current practice of murabahah (Warde, 2000; Saleem, 2005; Ayub, 2007; Raphaeli, 2009; Khan, 2010). Fostering such concerns is not inconsistent with socially responsible literature (see, for example, Graafland et al., 2004; Ullah et al., 2014; O'Mara-Shimek et al., 2015). We believe that more discourse of this sort can trigger serious efforts to steer the Islamic finance industry towards the ideal paradigmatic form.

Our study contributes new knowledge about the reality of Islamic finance in several ways. First, we find no evidence of widespread use of Islamic financing across non-financial firms, despite numerous claims regarding the growing importance of Islamic finance. We find that Islamic instruments penetrate long-term financing more than short-term financing. Our further analysis reveals that Islamic financing allows highly geared, less profitable firms (i.e., risky firms) to access further financing. This finding suggests that Islamic financing seems to appeal

to risky firms, who would otherwise face difficulties in accessing additional conventional financing. This insight, which has not been documented in prior studies, enhances our knowledge about the significant role of Islamic financing in helping risky firms in need.

Second, we find that the presence of profit and loss sharing (i.e., musharakah) in corporate financing is negligible, whereas the use of murabahah is prevalent. We discover that murabahah constitutes about 30% of corporate firms' use of Islamic financing instruments. Consistent with the prediction of moral-hazard-risk avoidance theory (Aggarwal and Yousef, 2000; Ayub, 2007), further analysis suggests that users with lower tangible fixed assets (to serve as collateral) exhibit a greater use of murabahah. This observation implies that collateral deficiency dis-incentivises financiers from sharing the risk (or losses) of corporate firms that are susceptible to managerial moral hazard. Financiers, in this case, will secure a fixed return by pushing the use of murabahah instead of offering profit and loss sharing. This intuition, which has not been documented in prior studies, advances our understanding of why murabahah has become a preferred instrument in Islamic corporate financing.

Third, we argue that murabahah can be abused so as to camouflage riba-based financing that deviates from profit and loss sharing theory. Although deviation from this theory can help weakly collateralised firms to access further financing, the prospect of riba being camouflaged through murabahah should trigger unreserved religious-based ethical discourse due to the exploitative motives such a practice may entail. Contentiously practised murabahah may as well trigger doubt on the ability of Islamic financing practice, in its current form, to offer a legitimate ethical financing alternative.

The remainder of this paper is organised as follows. We first present the literature review that includes the background on the Islamic finance industry, the findings of previous studies as well as the discourses that motivate our research questions, and detailed definitions of musharakah and murabahah. Next, we examine the extent and nature of the Islamic instruments used by non-financial firms. We then empirically analyse the characteristics of users. We also perform empirical analysis to elucidate the popularity of murabahah financing. In the penultimate section, we offer a critical discourse on murabahah as it is currently practised, from an ethical perspective. Finally we conclude the paper by offering some practical implications.

Literature review

Islamic finance industry: background

In terms of its ascendancy, the growth of Islamic financial assets worldwide is perceived to have exceeded 15% annually (Khan, 2010). The total assets in Sharia-compliant financial institutions doubled to US$900 billion between 2006 and 2011 (Financial Times, 2011). The Islamic finance industry has since been forecasted to expand by US$1.6 trillion in assets over three years as London pushes for an increased share of the global Islamic finance market (Financial Times, 2013). This industry appeals to the global market because of its potential for the creation of an ethical and stable financial system (Kayed and Hassan, 2011).

Prohibition of riba is one of the key features of Islamic finance,[1] and part of a wider ethical framework concerned with preserving justice and equity in financial relationships (Mews and Abraham, 2006). Although Islamic scholars have not been able to reach an absolute agreement on the definition of riba, they generally describe it as any addition to, or increase of, a thing

[1] The arguments in this paper are built mainly on the prohibition of riba. For the sake of brevity, other features of Islamic finance such as the prohibitions of gharar and forbidden activities are not covered here.

(e.g., money, goods or other form of instrument) over and above its original size or the amount lent, which involves an exploitation of the economically weak by strong and resourceful entities (Asad, 1980). Exploitation in this sense is categorically considered to be riba. Lending based on interest is considered illegitimate exploitation because the financier is guaranteed a return (i.e., interest income) even when the investment project being financed makes a loss.

Islamic corporate financing: what we know and what we do not

The prohibition of riba has inspired the development of various types of Islamic financing instruments, such as summarised in Appendix 1. However, it is still empirically unknown to what extent non-financial firms use Islamic financing in corporate financing. This gap in the knowledge motivates us to provide evidence that will answer our first research question:

> Q1: To what extent do non-financial firms use Islamic instruments in corporate financing, and why?

Using data collected from Islamic banks, several studies found that alternatives to profit and loss sharing, such as murabahah, have significantly dominated the Islamic capital market (Aggarwal and Yousef, 2000; Chong and Liu, 2009; Khan, 2010). Table 1 summarises the findings from these studies.

Insert Table 1 about here

Recognising that previous studies do not fully capture the extent of Islamic instruments used by corporate firms, our study contributes towards filling this gap by addressing our second research question:

Q2: Which type of Islamic instruments is most used by non-financial firms, and why?

Musharakah in the context of profit and loss sharing theory

In musharakah, the shareholders of a corporate firm and other suppliers of financial capital (e.g., banks) are envisaged to be partners. Each partner, also referred to as rabbul-mal, contributes financial capital in varying proportions and can choose to contribute human capital (i.e., management skill/expertise) to actively manage the underlying firm. In musharakah, the suppliers of financial capital will share both the upside and downside potential of the underlying investment projects undertaken by the partnership (i.e., the corporate firm). The ratio or percentage of profit sharing is pre-determined and agreed upon by the partners at the inception of the partnership contract. In the case of loss-making projects, the losses will be shared across partners according to the proportion of financial capital contributed. Therefore, musharakah is consistent with the Islamic concept of fairness whereby the parties to the contract will share in symmetric payoffs. Arrangements of this sort should not entail riba or illegitimate exploitation because musharakah partners are not guaranteed positive payoffs since their payoffs will depend upon the performance of the underlying investment projects.

Murabahah as an alternative instrument in the context of moral-hazard-risk avoidance theory

The Islamic finance industry is perceived to have prospered mainly through the use of murabahah financing (Financial Times. 2014). Murabahah is described as a “cost-plus sale”

contract, whereby parties to a genuine sale contract will bargain on a margin of profit (or mark-up) over the known cost (or principal amount) of an underlying asset. In the case of a credit sale, the payment of the principal amount plus the agreed mark-up is made by the buyer (i.e., corporate firm) to the seller (i.e., financier) on a deferred basis. This is called murabahah-mu'ajjal, which refers to an arrangement whereby a financier (e.g., an Islamic bank), upon request from a corporate firm, purchases an underlying asset from a third party, and then sells it to the corporate firm at cost plus a mark-up on a deferred payment basis. In Malaysia, murabahah-mu'ajjal with a long-term maturity is known as al-bai-bithaman ajil (BBA). The mark-up can be calculated either as a percentage of the underlying's cost, or as a fixed amount, which implies a fixed return on the investment for the financier (Raphaeli, 2009).

According to contemporary Sharia scholars, setting a selling price higher than the original spot price is permitted, provided that the risk of the underlying asset is borne by the financier until the ownership is transferred to the corporate firm. The fixed mark-up or profit margin can be viewed as the financier's compensation for bearing the risk associated with (temporary) ownership of the underlying asset. This risk refers to the potential inability of the corporate firm to purchase the underlying asset from the financier, which would cause the financier to incur administration costs in finding a new buyer. The profit margin is also viewed as a compensation for bearing after-sales risk. This refers to the risk of a defective underlying asset, in the event of which the corporate firm will claim compensation or repair costs from the financier, who is acting as the seller in the contract (Iqbal and Mirakhor, 2007).

The popularity of murabahah, as an alternative instrument to profit and loss sharing, has been described as the Islamic banks' rational response to their financial contracting environment that is susceptible to typical agency problems (Aggarwal and Yousef, 2000; Ayub, 2007). We argue

that murabahah, which entitles financiers a fixed return on their investment, seems more suitable for financiers or investors with low risk-taking incentives, who are neither interested in actively monitoring the activities of the corporate firms they finance, nor in sharing the risk (or losses) associated with the corporate managers' moral hazard.

Building upon the existing literature (Aggarwal and Yousef, 2000; Ayub, 2007), we identify two practical issues associated with profit and loss sharing. Our arguments are derived from the perspective of risk-averse financiers such as banks or investors with low risk-taking incentives, as opposed to equity investors. First, offering musharakah financing will expose financiers (i.e., non-managing partners) more to an asymmetric information environment (Ayub, 2007). In this scenario, the financiers' return on their investment will be exposed to the moral hazard of the managing partners, who manage the underlying projects or firm. Managing partners can manipulate reported profits to deceive non-managing partners, or abuse the partnership's resources to serve their private interests, or invest excessively in risky projects that may (unintentionally) increase the probability of losses being generated. This scenario is very similar to the agency problems associated with the separation of ownership and control of the firm, as frequently described in the corporate governance literature.

Second, monitoring is costly and, in the absence of proper monitoring by financiers, the potential for managerial moral hazard is great. In addition, it is simply not in the economic interest of the non-managing partners such as banks and other risk-averse investors to actively engage in managing or monitoring the underlying firm's activities because they generally require a return on their investment that is lower than that demanded by equity investors. This category of financiers prefers a fixed return on their investment (or priority of claims in the

case of the underlying firm's bankruptcy), which provides little incentive for them to monitor the projects undertaken by corporate firms' managers.

We argue that managerial moral hazard in firms with a lower asset base will expose financiers to greater risk due to their inability to fully recover investment losses, if any, by liquidating the firms' assets. Default risk can be reduced by having a larger asset base since the assets could be used as collateral (Scott, 1977). This implies that firms with a lower asset base tend to face higher default risk due to the lower collateral level. In this regard, we introduce moral-hazard-risk avoidance theory to enrich our understanding of the role managerial moral hazard plays in influencing the use of murabahah. This theory suggests that moral hazard in firms with a lower asset base will expose financiers to a greater risk of not being able to recoup any investment losses fully by liquidating the firms' assets. Consequently, greater collateral deficiency will cause financiers to demand a fixed return, and hence they will prefer to offer murabahah financing. Entitlement to a fixed return will save financiers from sharing the consequences of managerial moral hazard that frequently manifest in poor performance.

In sum, moral-hazard-risk avoidance theory predicts that a lower corporate asset base will induce financiers to impose a greater use of murabahah, hence a fixed return, in financing corporate firms. This is because the corporate assets in this case will be not sufficiently available to serve as security in dealing with the disastrous consequences of corporate managers' moral hazard. Therefore, we hypothesize that firms with a lower asset base will be associated with a greater use of murabahah financing. This hypothesis is tested in the empirical analysis section as an attempt to elucidate the dominance of murabahah in Islamic corporate financing.

Empirical analysis

Institutional background

Malaysia is a suitable setting for this study due to the significant Islamic capital market in the country. At the end of 2004, the market share of Islamic banking assets in Malaysia was 26.2% (Chong and Liu, 2009). In 2005, sukuk denominated in Malaysian Ringgit (MYR) dominated the global sukuk market with a 65.7% share (Wilson, 2008). The Malaysian government has indeed played an active role in promoting the use of Islamic instruments in corporate financing activities. The implementation of the Islamic Financial Services Act (IFSA), which took effect on 30 June 2013, represented a landmark initiative by the government to further promote the development of Islamic finance. Although such a conducive environment in Malaysia may have incentivised corporate firms in the country to finance their investment activities in Islamic way, little is known of the extent to which these firms have embraced Islamic financing.

The nature of Islamic financing used in Malaysia also presents an interesting case for discourse because learned Islamic scholars have contended that the emergence of Islamic banking and finance in Malaysia has been "going too fast, and that in its rush to grow, Malaysian finance was cutting too many corners" (Warde, 2000, p. 127). Islamic finance in Malaysia has flourished under a highly pragmatic approach, by challenging Malaysian Islamic scholars to pursue ijtihad in an effort to generate new ideas.[2] Warde (2000, p. 85) criticised the situation as follows: "A number of Islamic research centres and universities engaged in a vast effort to legitimate modern finance, and in particular to create an 'Islamic capital market' that would use specially designed interest-free bonds and other securities. Many Malaysian 'innovations' in that area are not deemed acceptable to Sharia boards in more conservative Gulf States". Our

[2] Ijtihad is "the efforts expanded by jurists to extract solutions to problems based on the principles of primary and secondary sources, where rules of behaviour are not explicitly addressed by the primary sources, i.e. *Quran* and *Sunnah*." (Iqbal and Mirakhor, p. x).

study is developed against the backdrop of such criticism. Scrutinising the extent and nature of the Islamic instruments used in corporate financing in Malaysia is crucial as its experience may well become a benchmark for emerging Islamic capital markets elsewhere in the world.

To what extent are Islamic financing instruments used in corporate financing?

Our examination of the annual reports of 816 corporate firms listed on the Main Market of Bursa Malaysia produced 60 companies (7%) that had used Islamic financing during 2012, and whose annual reports contained adequate information for the purpose of this study. The distribution of these firms, arranged by industry categories, is presented in Table 2. It is observed that the use of Islamic financing is spread across industries but the practice seems to be dominated by the trading and services industry. The effect of industry is further tested through regression analysis.

Insert Table 2 about here

Table 3 reports the descriptive statistics of both the Islamic and conventional financing instruments used during 2012 by the 60 corporate firms under study. Panel A reports that, on average, conventional borrowing represented a considerable portion of corporate financing, with an average amount of MYR1.2 billion. On average, Islamic financing accounted for MYR978 million of total corporate financing. Long-term financing dominated short-term financing in both cases. Long-term financing refers to financing contracts with a term to maturity longer than one year, and short-term financing refers to financing contracts with a maturity of one year or less. Conventional equity financing seems to have been the most popular mode of corporate financing, with an average amount of MYR3.1 billion.

Insert Table 3 about here

Panel B of Table 3 reports the descriptive statistics of the Islamic-to-conventional financing ratios for the 60 users of Islamic financing. The ratios indicate the extent of Islamic financing as compared to conventional borrowing. It can be observed that the average ratio for long-term Islamic financing over long-term debt is 50% while the average ratio for short-term Islamic financing over short-term debt is only 29%. This observation suggests that Islamic financing has gained a higher penetration rate in the case of long-term corporate financing.

Why do firms use Islamic financing in corporate financing?

This study reveals a very low penetration rate of Islamic financing among the 816 Malaysian corporate firms studied. This striking observation triggers the question of what type of firm considers Islamic instruments in their corporate financing. We employed mean/median comparison tests and probit regression to explore plausible answers to this query. The 60 users were matched, based on size and industry, with firms that did not use Islamic financing. We assigned the value of 1 to firms that used, and the value of 0 to firms that did not use Islamic instruments for financing activities. Due to the absence of theoretical studies on the determinants of corporate use of Islamic financing, we considered in our analysis the explanatory variables commonly used in capital structure studies. These were leverage ratios, size, profitability, liquidity, the market-to-book ratio, and tangibility (e.g., Scott, 1977; Bevan and Danbolt, 2002; Adam and Goyal, 2008; Dzolkarnaini, 2009). The definitions of these variables are presented in Appendix 2.

Comparative statistics for the Islamic financing users and non-users, together with the results of mean/median comparison tests, are reported in Table 4. It can be observed that users have a significantly higher level of borrowing, as measured by the ratio of long-term debt to total assets (LTD/TA) and the ratio of total debt to total assets (TD/TA). Islamic financing users are also significantly less profitable than non-users. Profitability (PROF) is measured as the earnings before interest, tax, depreciation and amortisation divided by total assets.

Insert Table 4 about here

We further test, by employing probit regressions, whether highly levered and less profitable firms have a greater tendency to resort to Islamic financing. The regression results are presented in Table 5. The results reported in columns 1 to 4 consistently suggest that Islamic financing tends to be used by less profitable firms and firms with higher leverage. These results imply that a firm's existing borrowing and profitability are two important factors that are associated with the use of Islamic financing. Difficulties of accessing the conventional debt market as a consequence of weak financial performance and a high level of borrowing can perhaps explain why these firms may have considered Islamic instruments for financing their investment activities. Islamic financing is a viable alternative for this category of firms due to possible adverse selection and high demand to invest in Islamic instruments created by the Islamic capital market (Godlewski, Turk-Ariss and Weill, 2013). If we define less profitable firms with higher leverage as riskier firms, then the results from Table 5, taken together, suggest that Islamic financing tends to help risky firms, who otherwise may face difficulties in accessing additional conventional financing. To our knowledge, this insight has not been documented in other studies; hence it forms a novel contribution of our study.

Insert Table 5 about here

Which type of Islamic instrument is used most often in corporate financing, and why?

This study contributes further by exploring the nature of the Islamic instruments used in corporate financing. Table 6 reports the types of Islamic financial instruments used by the 60 corporate firms in our sample. It shows that their reliance on profit and loss sharing instruments (i.e., musharakah) is negligible, comprising only 7% of the Islamic financing used. Murabahah (including murabahah-mu'ajjal as in BBA), as an alternative to profit and loss sharing, appears to be a preferred mode of Islamic financing, accounting for 30% of the Islamic financing used. The reliance on alternatives to profit and loss sharing has been amplified with the innovation of Islamic term notes and commercial papers, which represent about 10% of Islamic corporate financing in Malaysia. This is very much consistent with the adoption of a highly pragmatic approach that has encouraged Islamic scholars to generate new ideas for a more progressive Islamic finance (Warde, 2000). In addition, 36% of the Islamic financing in the sample are categorised as unclassified sukuk, whose nature is not ascertainable due to a lack of disclosure in the firms' annual reports.[3]

Insert Table 6 about here

The findings reported in Table 6 are consistent with the findings of previous studies that have documented the prevalence of murabahah in Islamic banking (Aggarwal and Yousef, 2000;

[3] These data limitations hamper the empirical investigation on sukuk, but dealing with this issue is beyond the scope of this study.

Chong and Liu, 2009; Khan, 2010). Instead of relying solely on data from Islamic banks, we contribute to the literature by presenting unique scientific evidence gleaned from corporate firms' annual reports to produce a more complete and recent picture of the reality of Islamic corporate financing in Malaysia. Our findings form part of a continuation of academic efforts to document the prevalent use of murabahah over the years.

The prevalent use of murabahah has raised concern over the extent to which such practice deviates from profit and loss sharing as the ideal form of Islamic finance. Therefore, we attempt to empirically explore a plausible rationale for the use of murabahah as an alternative to profit and loss sharing. The dependent variable is the ratio of murabahah to the total value of Islamic financing used by firms. Tobit regressions are employed in this analysis due to the presence of many observations with zero value in the case of non-users of murabahah. The regression results are reported in Table 7.

Insert Table 7 about here

The results in columns 1 to 4 of Table 7 consistently show that leverage, as measured based on long-term debt (LTD/TA) and total debt (TD/TA), is negatively related to the extent of murabahah use. This observation may suggest that firms that rely on a greater use of murabahah may have experienced difficulties in accessing conventional borrowing (as shown through low leverage). There could be a number of reasons why a firm might face difficulties in accessing conventional borrowing. However, data limitations restrict us from exploring this further.

Another observation from Table 7 is the significant negative relationship between tangibility (TANG) and the amount of murabahah used by firms. Tangibility is defined as the ratio of

tangible fixed assets (net of accumulated depreciation) to the firm's book value of total assets. This variable measures a firm's collateral level. The moral-hazard-risk avoidance theory introduced in this study predicts that the tendency for financiers to demand a fixed return will be greater for firms with a lower asset base. This is due to the unavailability of sufficient assets to serve as collateral against the firms' downside potential in the presence of managerial moral hazard. This prediction is consistent with the negative relationship between tangibility and the extent of murabahah use, as reported in Table 7. In this case, financiers would be entitled to a fixed return instead of return that would vary according to the performance of the underlying corporate firms. Imposing a fixed return, as in the case of murabahah, is a practical solution that allows financiers to avoid sharing losses resulting from corporate firms' managerial moral hazard. Murabahah financing can thus be viewed as a risk management strategy from the Islamic financiers' perspective, which is an interesting insight we offer in this study. Nevertheless, such a risk management strategy obviously means that financiers do not share both the upside and downside potential of corporate firms. Further, there must be ethical concerns associated with imposing a fixed return on counterparties in a weak bargaining position. These issues are discussed in the following section.

Discussion

Is murabahah as practised ethically sound?

Questioning corporate practice has been a persistent agenda among ethicists when placing business ethics at the heart of corporate practice (Painter-Morland, 2010; Beverungen, Dunne and Hoedemaekers, 2013; Moore, 2015). While previous discourses commonly delve into conventional corporate practice, critical discourse about Islamic corporate practice is uncommon. Therefore, we enrich the literature on business ethics by asking our third research question:

Q3: Can murabahah as practised be considered ethically sound?

This question is answered through our critical discourse on murabahah practice, which aims to reinforce some ethical issues as the practice tends to deviate from the religious-based ethical objective of promoting fair transactions. This discourse is crucial because our study thus far reveals the economic significance of murabahah as an alternative to profit-and-loss-sharing-based financing. Table 7, presented earlier, documents some evidence that murabahah financing is more common among firms in the trading and services industry (TRADS) in Malaysia. It was also indicated earlier in Table 2 that firms in the trading and services industry had embraced Islamic financing more than firms in other industries. These findings, taken together, suggest that murabahah is playing a key role in fuelling the growth of Islamic finance. Therefore, it is a socially responsible call to urge that murabahah practice *vis-à-vis* Islamic finance moves forward in a universally acceptable direction. Promoting truly Islamic practice does correspond with socially responsible conduct that serves, constructively, the needs of society (Graafland, Mazereeuw and Yahia, 2004; Ullah, Jamali and Harwood, 2014; O'Mara-Shimek, Guilllen and Banon Gomis, 2015).

Deviation from profit and loss sharing theory

Although the murabahah model has been allowed by Sharia scholars to be implemented in financing transactions, the implementation has not been without issues. There are issues associated with the way murabahah is structured in practice. It is commonly acknowledged that the murabahah structure is often used to mimic conventional borrowing (Financial Times, 2014). In many cases, a financier such as an Islamic bank will simply finance a specific asset or investment project desired by a corporate firm, while expecting to receive a specified profit,

which does not vary according to the profit- or loss-making position of the underlying asset or project. The financier's exposure to the corporate firm's default risk can also be minimised because the underlying asset being financed can simultaneously be used as collateral until the cost-plus-mark-up amount is fully settled by the corporate firm (Ayub, 2007). The certain profit and the presence of collateral to protect the financier's interest clearly indicate a deviation from profit and loss sharing, the epistemological foundation of Islamic finance.

In addition, Islamic banks are naturally not genuinely interested in the trading of the underlying asset. Based on their personal recollections of murabahah as practised by Islamic banks, some bankers claimed that Islamic banks tend to keep ownership of the underlying asset for a very short period before the asset is sold to the client (e.g. corporate firm). "It may not amount to more than a few seconds as a vast majority of transactions are closed simultaneously…" (Saleem, 2005, p. 23). Selling the underlying asset immediately to the previously identified client following a purchase from the original seller means that the Islamic banks are hardly exposed to the ownership risk associated with the asset at all. "What is more, since their ownership period can be measured in seconds, the banks do not assume any operational risks, normally associated with trading activities. Indeed, in practice, banks purchase the commodity or goods only after the customer has agreed in writing to purchase it from the bank at a profit." (Saleem, 2005, p. 23). We argue that the guaranteed and immediate nature of the onward sale to the customer not only forms a deviation from profit and loss sharing, but also renders the justification for the profit margin as compensation for ownership risk deceptive.

Substance over form

In Malaysia, murabahah, as in the case of BBA for property financing, typically involves the purchase of an underlying asset by an Islamic bank directly from a customer. The bank then

immediately sells the same underlying back to the customer at cost plus a specified profit. This buy-back arrangement, known as *bai' al 'inah*, is not considered to be Sharia-compliant in many Gulf States' jurisdictions (Ayub, 2007). We acknowledge that Islamic values and practices may differ widely among Muslims (Graafland, Mazereeuw and Yahia, 2006). However, the transaction just described is, more often than not, simply trading in disguise or dressed up with legal form, in which the bank has no liability or responsibility to compensate the customer in the event of delivery failure, or an underlying that is not fit for use or occupation, or that is defective. This reality renders the justification for profit as compensation for after-sales risk deceptive.

In the case of *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors, Koperasi Seri Kota Bukit Cheraka Bhd (Third Party) & Other cases [2009] 1 CLJ 419,* the bank had purchased the property directly from the customer and thereafter sold the same property to the customer at a higher price. It was held by the court that the transaction was not a *bona fide* sale but a mere financing transaction. It was further held that the bank has to be a genuine seller in order for such transactions to be acceptable from an Islamic perspective. This clearly demonstrates that the substance of such murabahah practice forms not only a deviation from profit and loss sharing theory, but also a camouflage of riba-based financing activity.

Camouflaged riba

In murabahah as practised, we can presume that the specified profit or mark-up is typically non-negotiable from the perspective of the customer (i.e. firm), who is in a weak bargaining position, but in need of financing to finance growth opportunities. The results presented earlier suggest that firms that resort to Islamic financing are normally those with weaker financial performance (Table 5), and that those that deviate from profit and loss sharing instruments tend

to have a lower asset base (Table 7). These conditions may have made it difficult for these firms to access not just conventional loans, but also profit and loss sharing instruments, due to the moral-hazard-risk avoidance behaviour of financiers. Accepting a fixed cost imposed through murabahah financing allows these financially weak firms to access further financing.

Although deviation from profit and loss sharing helps financially weak firms to access financing, the certainty of the profit margin for the financiers has been criticised as simply camouflaging riba-based conventional lending. In addition, it has been established in the literature that Islamic banks determine their profit margin by mimicking the interest rate charged on identical conventional lending (Saleem, 2005; Chong and Liu, 2009; Raphaeli, 2009; Khan, 2010). The rate does not necessarily refer only to a standard benchmark rate such as LIBOR but also incorporates a risk premium or excess, which at times could result in excessive profits for the Islamic banks. Such murabahah practice is feared to entail riba.

We acknowledge that it is almost impossible to discern the primary and true intentions of the parties involved in murabahah transactions. Nevertheless, Islamic teaching generally approves only of profit levels that do not lead to exploitation, which means that excessive pricing and/or harm to the community are not looked upon positively (Ali, Al-Aali, and Al-Owaihan, 2013). This Islamic view is not inconsistent with the pursuit of profit from the perspectives of ethics and corporate social responsibility (Vranceanu, 2014). Unfortunately, in the case of murabahah as practised today, anecdotal evidence suggests that customers have complained bitterly about the Islamic banks' deviation from religious objectives, and that most Islamic banks collect higher profit margin than the interest charged by conventional banks (Raphaeli, 2009). For example, in the case of *Bank Islam Malaysia Berhad v. Adnan Omar [1994] 3 CLJ 735*, it was held that a murabahah transaction had resulted in the customer being liable to pay an amount

far higher than he would have been liable to pay in a conventional loan with interest. Such example of murabahah practice has clearly produced a burdensome outcome instead of the fair transactions intended in Islam.

Society's wellbeing will be enhanced if the virtues of Islamic frameworks are truly implemented (Uddin, 2003; Moore, 2015; O'Mara-Shimek, Guilllen and Banon Gomis, 2015). However, the murabahah practices just described seem far from enhancing society's wellbeing. Our ethical discourse has highlighted three key moral dimensions that describe plausible characteristics of murabahah as practised today and these are summarised in Table 8. Although deviating from profit and loss sharing would help financially weaker firms to obtain financing that would otherwise not be obtainable through the conventional debt market, the way murabahah is constructed in practice has caused great concern over whether it has been exploited irresponsibly and deviates from fair transactions. "While ethical duties emphasize responsibility for engaging in business activities, exploitation is prohibited" (Ali, Al-Aali, and Al-Owaihan, 2013, p. 471). The fact that murabahah is so often used in practice (as reported in Table 6) provides a compelling case for bringing this ethical discourse forward. The ethical dimension of murabahah as practised has largely been neglected by the mainstream literature. Our study can only provide a foundation for the socially responsible exploration that must continue.

Insert Table 8 about here

Conclusions

In theory, profit and loss/risk sharing is widely accepted as the paradigmatic form of Islamic finance. While the Islamic finance industry is claimed to have been growing at unprecedented

rates, very little is known as to the extent to which the theory has been implemented in corporate financing practice. Although prior studies find that Islamic banks tend to deviate from profit and loss sharing practice, the literature falls short of providing empirical evidence on Islamic corporate financing practice among non-financial firms. This research gap allows our study to contribute empirical evidence that reveals the gap between the theory and practice of Islamic corporate financing. In doing so, we have addressed three research questions:

Q1: To what extent do non-financial firms use Islamic financing, and why?

Q2: Which type of Islamic instruments is most used by non-financial firms, and why?

Q3: Can murabahah as practised be considered ethically sound?

Unlike prior studies that have relied on data from Islamic banks, we gathered data from non-financial firms. We find that profit-and-loss-based instruments (i.e., musharakah) form only 7% of Islamic financing used by corporate firms in Malaysia. Alternatives instruments, such as murabahah (including murabahah-mu'ajjal as in BBA), form about 30% of the Islamic instruments used by the firms. These findings advance our knowledge about the reality of Islamic corporate financing, which hardly promotes profit and loss/risk sharing. We further explain below how the remaining findings of this study contribute new knowledge to the literatures on corporate social responsibility, business ethics and Islamic finance.

In terms of the contribution to corporate social responsibility, the results of our empirical analysis suggest that Islamic financing facilitates highly geared, less profitable firms' access to financial capital. These risky firms, which otherwise would face difficulties in accessing conventional financing due to their high default risk, would normally be shut out of the conventional capital market. Islamic financing can be seen as complementing the role of the

conventional capital market when less fortunate firms are financed by Islamic instruments in a way that gears up their business activities to foster economic growth. The empirical evidence presented here reinforces the findings on the contribution Islamic financing makes to the welfare of corporate firms. By implication, corporate practitioners can see Islamic financing as a second-best solution in their efforts to obtain further financing for the firms they manage. This is an interesting insight that has not been articulated in prior studies.

In terms of its contribution to business ethics, this study offers a critical review of the prospects of Islamic finance practice in terms of fostering fair transactions. There is no doubt that Islamic finance aims to promote good business ethics as prohibition of riba is part of a wider ethical framework (Mews and Abraham, 2006). However, our concern is that instruments such as murabahah can be exploited by financiers, allowing them to profit from financially weak firms. The results of our regression analysis suggest that weakly collateralised firms are more likely to rely on a greater use of murabahah. The practice of imposing a fixed profit margin on a hardly genuine trade should trigger an ethical concern, especially when the counterparty is in a weak bargaining position. Taking the profit margin as a compensation for bearing ownership risk hardly adds up in the absence of a genuine trade. The potential for camouflaging riba in this way should cause a grave concern too. If widespread, it would render Islamic finance practice substantially indistinguishable from conventional finance. Although imposing a fixed return for financing projects is perhaps a common risk management strategy employed by financiers in the presence of the potential moral hazard among corporate managers, flawed murabahah practice risks the legitimacy of Islamic finance. Therefore, apart from implementing ethically sound financing instruments, there is a responsibility to ensure legitimate murabahah practice, which ultimately lies on the shoulders of the Sharia scholars who serve on the Islamic banks' Sharia supervisory boards.

In terms of its contribution to Islamic finance, it is important to note that this study is not criticising the murabahah principle. The critical arguments are levelled at the potentially flawed murabahah practice. The potential gap between the principle and practice of murabahah perceived in this study provides a case for the furthering of this discourse. More research to explore the gap is important because our findings show that murabahah is a significant component of Islamic corporate financing practice. The murabahah structure, if abused widely in the way described in this paper, will hardly render Islamic finance practice a real alternative to the controversial practice of conventional finance. Implementing Islamic financing by pressing a fixed cost on financially weak firms may fuel credit bubbles in the same way that conventional finance fuels recurring financial crisis.

To conclude, although deviation from profit and loss/risk sharing theory can help weak firms to access financing, any attempt to camouflage riba should alarm us from a religious-based ethical perspective. We suggest that murabahah financing deserves a positive ethical and religious appraisal if it is carried out with fairness instead of being exploited as a rent-seeking instrument. The empirical evidence and critical discourse of this study urge Sharia scholars, policymakers and regulators to scrutinise more closely the practice of Islamic corporate financing. It is necessary to bring about a change in the policymaking and regulatory approach to Islamic instruments, with three clear objectives: to scrutinise that the instruments are not abused by financial institutions as rent-seeking tools; to innovate Islamic financing practices that fulfil their potential as a real alternative to conventional financing; and to provide incentives that would further encourage the use of profit and loss sharing instruments. Islamic finance scholars and practitioners have to work hand-in-hand with policymakers and regulators

to formulate appropriate incentives if they are to achieve the abovementioned objectives. Our study sets up the motivation for such serious efforts to be initiated.

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Table 1

Findings from prior studies on Islamic financing instruments offered by Islamic banks

Author(s)	Period	Sample	Findings
Aggarwal and Yousef (2000)	1995	Large Islamic banks	• Murabahah 45.1% • Musharakah 16.3%
Chong and Liu (2009)	2004	Islamic banks in Malaysia	• Murabahah 56.9% • Musharakah 0.4%
Khan (2010)	2006	Major Islamic banks around the world	Percentages of murabahah: • Al Rajhi Bank 42% • Kuwait Finance House 62.7% • Dubai Islamic Bank 55.6% • Bank Islam Malaysia 89.7%

Note: Musharakah is a profit and loss sharing instrument. Murabahah is an alternative instrument.

Table 2

Distribution of Islamic financing users by industry categories

Industry	Frequency	%
Trading and services (*TRADS*)	20	33
Properties and REITs (*PROPS*)	11	18
Industrial production (I*NDS*)	9	15
Construction (*CONS*)	6	10
Other industries	14	24
Total	60	100

Table 3

Descriptive statistics of corporate financing

Panel A: The amount of Islamic and conventional financing

	Islamic financial instruments (MYR million)			Conventional			
				Debt instruments (MYR million)			Equity (MYR million)
	Short term (ST)	Long term (LT)	Total	Short term (ST)	Long term (LT)	Total	
Mean	144	848	978	392	776	1,168	3,107
Median	10	60	102	72	32	154	528
Min	-	-	-	-	-	-	35
Max	2,000	14,499	15,549	4,923	13,216	14,820	36,137
Stdev	377	2,294	2,432	852	2,096	2,592	6,955

Panel B: Islamic-to-conventional financing ratios

	Total IFIs / Total Debt	LT IFIs / LT Debt	ST IFIs / ST Debt
Mean	0.41	0.50	0.29
Median	0.33	0.51	0.12
Min	0.02	-	-
Max	1.00	1.00	1.00
Stdev	0.31	0.38	0.34

Note: IFIs = Islamic financial instruments

Table 4

Comparative statistics between users and non-users of Islamic financing

	Mean			Median		
	Users (*N*=60)	Non-users (*N*=60)	*t*-test (*t*-value)	Users (*N*=60)	Non-users (*N*=60)	Mann-Whitney Test (*z*-value)
LTD/TA	0.18	0.11	2.74***	0.16	0.07	2.87***
TD/TA	0.32	0.20	4.07***	0.29	0.18	3.94***
PROF	0.05	0.11	-2.54***	0.08	0.09	-2.12**
LIQD	1.70	3.11	-1.53	1.39	1.67	-1.70*
MTB	1.14	1.22	-0.43	0.94	0.96	-0.08
TANG	0.41	0.39	0.34	0.40	0.40	0.08
SIZE	14.16	13.95	0.65	14.16	13.99	0.42

The table presents the comparative statistics for the characteristics of users and non-users of Islamic financing. ***, ** and * indicate statistical significance at the 1%, 5% and 10% levels, respectively (two-tailed test).

Table 5

Why firms use Islamic instruments in corporate financing?

	(1)	*(2)*	*(3)*	*(4)*
LTD/TA	2.82***	2.98***		
	(2.65)	(2.72)		
TD/TA			2.64***	2.61***
			(3.15)	(3.10)
PROF	-6.61***	-7.40***	-6.04***	-6.37***
	(-3.07)	(-3.14)	(-2.73)	(-2.76)
LIQD	-0.04	-0.04	-0.02	-0.02
	(-1.50)	(-1.60)	(-1.04)	(-0.99)
MTB	0.50	0.54	0.59	0.61
	(1.31)	(1.39)	(1.53)	(1.56)
TANG	0.30	0.36	0.29	0.31
	(0.61)	(0.72)	(0.58)	(0.62)
SIZE	-0.05	-0.06	-0.04	-0.04
	(-0.64)	(-0.68)	(-0.44)	(-0.46)
TRADS		0.14		0.09
		(0.42)		(0.26)
PROPS		-0.08		-0.01
		(-0.22)		(-0.04)
INDS		0.37		0.15
		(0.96)		(0.41)
CONS		0.27		0.14
		(0.60)		(0.32)
CONSTANT	0.90	0.89	0.28	0.28
	(0.77)	(0.73)	(0.24)	(0.24)
Pseudo R^2	0.14	0.15	0.15	0.16
Log pseudolikelihood	-71.30	-70.60	-70.40	-70.28
Wald χ^2	16.81***	16.33*	21.66***	21.02**

Probit regressions for 120 observations. The dependent variable is binary (1 = firm uses Islamic financing; 0 = firm does not use Islamic financing). All variables are defined in Appendix 2. Robust standard errors are used (not reported). *z*-statistics are reported in parentheses. ***, ** and * indicate statistical significance at the 1%, 5% and 10% levels, respectively (two-tailed test).

Table 6

Distribution of Islamic instruments in corporate financing

Islamic financial instruments	MYR billion	%
Musharakah	4.1	7
Murabahah (including BBA)	17.6	30
Ijarah	5.8	10
Islamic term notes and commercial papers	5.9	10
Unclassified sukuk*	21.3	36
Others	4.0	7
Total	58.7	100

*Note: Inadequate disclosure in firms' annual reports

Table 7

Why firms use murabahah in corporate financing?

	(1)	*(2)*	*(3)*	*(4)*
LTD/TA	-4.02*		-5.56***	
	(-1.86)		(-2.80)	
TD/TA		-5.04**		-5.39***
		(-2.49)		(-2.87)
PROF	1.98	-1.73	-0.03	-3.99
	(0.52)	(0.42)	(-0.01)	(-1.07)
LIQD	-0.38	-0.48	-0.51	-0.63
	(-1.23)	(-1.57)	(-1.46)	(-1.84)
MTB	-1.77**	-1.63**	-1.06	-1.25
	(-2.45)	(-2.22)	(-1.24)	(-1.48)
TANG	-2.21**	-2.50**	-3.15***	-3.40***
	(-2.18)	(-2.45)	(-3.41)	(-3.59)
SIZE	-0.23	-0.18	-0.28	-0.28
	(-1.15)	(-0.94)	(-1.46)	(-1.53)
TRADS	1.32*	1.17	2.25***	2.25***
	(1.71)	(1.52)	(2.79)	(2.77)
PROPS	-0.14	-0.26	0.61	0.48
	(-0.17)	(-0.30)	(0.76)	(0.61)
INDS	-0.13	0.70	-0.17	-0.73
	(-0.14)	(0.74)	(-0.21)	(-0.87)
CONS	-0.56	-0.23	0.14	0.54
	(-0.58)	(-0.24)	(0.14)	(0.57)
CONSTANT	6.01	6.50**	7.88	9.16
	(2.16)	(2.46)	(2.83)	(3.48)
Pseudo R^2	0.10	0.12	0.18	0.18
Log likelihood	-96.14	-94.60	-59.12	-58.99
No. of observations	99	99	40	40

Tobit regressions. The dependent variable is the ratio of murabahah to total Islamic financing used by firms. Columns (1) and (2) include all Islamic financing users. Columns (3) and (4) include only the users of murabahah and/or musharakah. All independent variables are defined in Appendix 2. Robust standard errors are used (not reported). *t*-statistics are reported in parentheses. ***, ** and * indicate statistical significance at the 1%, 5% and 10% levels, respectively (two-tailed test).

Table 8

Moral dimensions of murabahah as practised today

Moral dimension	Parameters
Deviation from profit and loss sharing theory	• Profit to the financier does not vary according to the performance of the underlying asset or project being financed • Financier bears negligible ownership risk associated with the underlying asset due to immediate (re)sale of the asset
Substance over form	• It is essentially a financial transaction due to the absence of a genuine trading activity • Doubtful justification for the entitlement to fixed profit
Camouflaged riba	• The mark-up is hardly negotiable by customer (i.e. firm), who is typically in a weak bargaining position • The mark-up rate may mimic or greater than the interest rate charged on an identical conventional loan

Appendix 1

Different types of Islamic financial instruments*

Classification	Participatory/Non-participatory	Islamic financial instrument	Specific nature
Debt-like instruments	Non-participatory	Murabahah	Cost-plus sale
		Tawarruq	An extension to Murabahah involving 3rd party
		'Inah	Sell and buy back
		Ijarah	Leases
		Istisna'	Contract to manufacture an asset
Equity-like instruments	Participatory/Profit and loss sharing	Musharakah	Partnership: each party contributes capital
		Mudarabah	Partnership between supplier of capital and managing partner

*adapted from Minhat and Dzolkarnaini (2016)

Appendix 2

Variable Definitions

Variable Name	Definitions
LTD/TA	The ratio of long-term debt to total assets.
TD/TA	The ratio of total debt to total assets.
PROF	The ratio of earnings before interest, tax, depreciation and amortisation (EBITDA) to total assets.
LIQD	The ratio of current assets to current liabilities.
MTB	The ratio of market value of equity to book value of equity.
TANG	The ratio of tangible fixed assets net of accumulated depreciation to total assets.
SIZE	The natural logarithm of total assets.
TRADS	Trading and services industry
PROPS	Properties and REITs industry
INDS	Industrial production industry
CONS	Construction industry